

**FINAL FILED COMMENTS OF THE
NATIONAL RETAIL FEDERATION
CONCERNING THE DISCLOSURE OF DEBIT CARD FEES**

Before the

**Federal Reserve Board
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Comments of the National Retail Federation Concerning the Disclosure of Debit Card Fees

The Board has asked for comment on an important economic and consumer protection issue – the disclosure of debit card fees. The inquiry raises questions as to the adequacy of existing disclosures required by the Electronic Fund Transfer Act. In essence, the Board asks whether varying fees charged consumers by banks (account-holding institution) for payment acceptance at point of sale in retail stores (the merchant or other provider of service) are meaningfully understood by account holding consumers. It is our observation that they are not. We should also note that this matter has implications for payment acceptance generally and has potentially significant economic consequences. This long simmering matter deserves careful Board and Congressional consideration.

By way of background, the National Retail Federation is the world's largest retail trade association, with membership that comprises all retail formats and channels of distribution including department, specialty, discount, catalog, Internet and independent stores as well as the industry's key trading partners of retail goods and services. NRF represents an industry with more than 1.4 million U.S. retail establishments, more than 23 million employees - about one in five American workers - and 2003 sales of \$3.8 trillion. As the industry umbrella group, NRF also represents more than 100 state, national and international retail associations.

We should also note that the retail industry is extremely competitive. The net margin in most retail establishments has historically been very narrow (on the order of 2%). In recent years relentless price pressure from large discounters has caused those margins to tighten even further. This demand to deliver value to consumers has made retailers exquisitely sensitive to the real cost paid for merchandise by our customers.

As to the issue before the Board, virtually all of our U.S. members accept debit cards, on a signature-based platform (commonly called "off-line"), a PIN-based platform (commonly called "on-line), or both. We have a great deal of familiarity with these products, both from our, and from our customers', perspective. Based on that experience we wish to emphasize to the Board that there are several hidden debit fees assessed at the time of purchase, deserving of review. To appreciate their effect, it may be helpful to summarize the most common types of debit card transactions and the manner in which their fees are imposed on consumers.

General

There is a difference between debit card payment types. One (on-line) is faster and more secure. The other (off-line) is more prone to mistakes and fraud.

Happily, the better system is less expensive. But many banks do not like it because they aren't able to charge as much for using it. Therefore, these banks are trying to push consumers to use the more expensive, inferior system by assessing transactions fees to account holders who choose the cheaper, better system. But they do not disclose their fees at the point of sale where consumers might readily see that their bank is assessing and others are not; instead they disclose only in their annual and periodic statements where the information gets lost or it appears that the merchant is imposing the fee.

Off-Line Transactions

In the "off-line" environment a consumer presents a debit card issued by the account-holding institution. These cards generally carry a VISA or MasterCard association branded name (such as "VISA Check"). The customer typically presents the card to the merchant for payment at point of sale. From the consumer's perspective, the card is processed in a manner similar to that for branded credit cards. The customer "signs" sales media to demonstrate his or her agreement to make the purchase. He or she may punch a "credit"-denominated button at the merchant's point of sale terminal, even though it is in fact a debit transaction. The transaction may be routed over branded networks and, within a day or three, an amount is debited from the consumer's account at the account-holding institution.

A portion of the debited amount is then credited to the retailer's account at the merchant bank. The balance, typically between one and two percent of the transaction amount, is distributed largely as *interchange* to financial institutions who in some manner "touch" the transaction, primarily the account-holder's bank. Consumers are generally oblivious to the amount they have been charged to accomplish the transaction because, through various means, the banks and their card associations virtually *require* merchants to hide the charge in the price of the goods or services.

For example, their rules require that a merchant's most prominently advertised price *must* be a fully loaded price, inclusive of the fees the account-holding institutions effectively will retain from the debit-using consumers' accounts for off-line transactions. This means, by way of simple illustration, that merchandise a retailer might just be able to afford to sell for \$99, in return for cash or a check drawn from a consumer's account, must be offered at \$100.25 (assuming one and one-quarter percent interchange) to cover the fees charged by the consumer's debit card issuing bank. Indeed, if every consumer presented a paper check, rather than a Visa CheckCard, for example, these purchases would cost roughly a dollar less, per transaction, than they do today.

With the increasing penetration of debit, consumers are more aware that use of debit card products results in money being withdrawn from their demand deposit accounts, just as if they had used a check. However, in speaking with

our customers, retailers have found that very few consumers are aware that all customers are paying substantially more for merchandise because many choose to use a “plastic check” rather than a paper one.

On-Line Transactions

In an “on-line” environment a consumer also presents a debit card issued by an account-holding institution. These cards typically carry a network branded name (such as STAR or NYCE). Again, the customer typically presents the card to the merchant for payment at point of sale. From the consumer’s perspective, the card is processed in a manner similar to that for an ATM card. The customer enters a PIN to demonstrate his or her agreement to make the purchase. He or she may punch a “debit” or “ATM”-denominated button at the merchant’s point of sale terminal, accurately reflecting the fact that it is a debit transaction. The transaction may be routed over regional debit networks and, within a matter of hours, an amount is debited from the consumer’s account at the account-holding institution.

The entire debited amount, usually minus a flat fee, is then credited to the retailer’s account at the merchant bank. Historically, a very small amount was distributed to the entities that processed the transaction (i.e. pennies). However, in recent years financial institutions have substantially increased their fees (from 5 to 65 cents per purchase) to provide “interchange” to those who touch the transaction. Like off-line fees, these new interchange fees are also hidden from consumers.

On the positive side, on-line PIN debit transactions could offer significant benefits to consumers, banks and merchants. Banks, by encouraging consumers to use on-line debit rather than checks or cash, avoid the cost of handling those payment types and many of the risks associated with more readily counterfeited checks (and other forms of tender). Retailers receive faster payment than with checks (though not as fast as with cash) and avoid some costs and risks as well, although it requires that they invest in point of sale equipment to realize these benefits. Consumers achieve the greater security that PIN transactions make possible and, although they lose some “float” on funds, have a more ready access to the actual balances available in their accounts. Of course, all of these benefits are premised on consumers’ willingness to use PIN debit and retailers’ willingness to invest in the equipment necessary to accept it. In a classic “chicken and egg” scenario, maximization of one depends on the existence of the other.

Incentives and Disincentives

The intrinsic benefits of PIN debit to financial institutions is quite apparent. Indeed, the cost avoidance they make possible, vis-à-vis checks, is one of the reasons PIN debit has been so prominently employed by banks in other countries

and helps explain the nominal cost with which it was first introduced into the U.S. It has been widely reported that financial institutions could save between 30 and 50 cents in handling costs for each check avoided. Unfortunately, the U.S. market has been distorted.

The introduction of expensive off-line debit access to consumers' demand deposit accounts greatly discouraged the rapid proliferation of PIN debit as a substitute for checks at point of sale, and slowed the aforementioned "chicken and egg" spiral of use and acceptance necessary for PIN debit to blossom. The benefits of what should have been a win-win-win for consumers, retailers and financial institutions became instead a tilted scale in which the primary winner was the latter, at the expense of the first two, and the efficiency of the economy as a whole.

For years the banks' card associations, effectively prohibited retailers from distinguishing between off-line signature debit and on-line PIN debit at point of sale. The same entities encouraged their member banks to tell consumers that they should avoid cheaper PIN debit transactions by instead (somewhat illogically) pressing the "credit" button in order to accomplish a debit transaction and thus trigger the much more expensive interchange fees discussed above.

Many retailers compete by aggressively lowering the prices their customers pay, which ordinarily would have given merchants significant incentives to install PIN equipment at point of sale. But their inability to steer customers to the most cost favored alternative (and to reward those customers with lower prices) meant that the investment in PIN equipment was far less beneficial than it might have been. A lack of on-line PIN accepting merchants meant there were fewer opportunities for consumers to experience on-line transactions; fewer opportunities to become familiar with the process at point of sale, and receive the safer, more secure, and economically beneficial consequence of lower than off-line prices that PIN might have made possible.

Meanwhile, banks moved to maximize their economic advantage. Of course, profit maximization can be an effective force in free and open markets. In conjunction with price transparency, it allows buyers to choose the most price advantageous products and services, generally from those sellers who maximize their profit by finding means of lowering their costs so as to attract the greatest number of buyers.

On the other hand, if the true price of a product or service can be hidden, for example by forcibly bundling its cost into retail purchases, consumers are less able to determine the value of the bundled service, and thus become less sensitive to the cost value equation.

Still, many retailers attempted to encourage consumers to use cheaper, safer and more efficient PIN debit by suggesting it at point of sale. These efforts

to “steer” took several forms. If they were able to determine that a proffered card was PIN-debit enabled, sales associates might ask the customer if he or she would enter a PIN. Some equipment was programmed to ask for a personal identification number if the customer swiped a card known to be PIN debit enabled, and so forth. This resulted in modest movement toward the higher quality form of payment (hampered in part because accurate identification of the cards was in many cases difficult).

However, in the past several years, another disincentive to use of PIN debit has been adopted by many financial institutions. These account holding institutions have begun to charge their customers yet another fee if they enter their PIN at a merchant’s point of sale terminal.

Over the past few years we have observed fees ranging from fifty cents per purchase to as much as \$1.50 per transaction. These fees have virtually no rational relationship to the nature of the transaction, except one: they provide a powerful **dis**incentive for consumers to continue to use PIN debit.

Consequences of Obfuscated Disclosures

Debit cards open the prospect to a near cashless society. Yet a consumer who thinks she is using her PIN debit card to purchase a discount paperback book for \$9.95 is likely to be shocked if she later learns that her demand deposit account has been debited somewhere between \$10.45 and \$11.45 for what she thought was a less than ten dollar purchase. A 12-ounce can of soda, purchased at a convenience store, could cause a consumer’s account to be debited by nearly \$3.00.

It does not take many of these experiences to train consumers to swear off PIN debit cards, not just for low dollar purchases, but for higher dollar transactions as well. Logically, consumers will not consciously choose to spend an extra dollar to enter their PIN, even on a two hundred dollar anniversary gift purchase, if they believe they have an opportunity to avoid the charge.

The proffered debit opportunity is to forego the win-win-win advantages of PIN debit and instead complete the transaction on one of the “off-line” debit cards. The consumer does not see that the cost of the transaction has been driven up nearly \$2.50 by the hidden interchange fee, he sees only that “someone” has not declared that an additional dollar will be debited from his account if he uses a PIN.

Retailers have clear anecdotal experience that both the hidden interchange fees banks receive and their surcharges for on-line debit are misunderstood by their customers.

Retailers often see first-hand the calculated inadequacy with which these fees are disclosed to the account holding institutions' customers. We see it because many customers come to us with their bank statements and express their surprise (to put it mildly) that they have been charged for entering their PIN, oftentimes at the retailer's urging. They tell us, in so many words, that they never would have entered their PIN if they'd known that "someone" was going to charge them anywhere from 50 cents to \$1.50 for doing so. In some cases they will belatedly discover that they have incurred multiple charges for PIN debit usage.

Their comments reveal other things as well. First, is that regardless of the fact financial institutions might have placed these fee disclosures in some communication to their customers – those communications clearly are not "clear and conspicuous" – certainly if by that it is meant they are to be delivered in a manner reasonably calculated to inform consumers of the pending imposition of the fee. Too many customers too often report to us their surprise for initial disclosures to be considered adequate.

The second thing their comments reveal is, who that "someone" is? As retailers have reviewed customers' bank statements with them as a consequence of the customers' complaints about these fees, we and our customers have made a surprising discovery. In many cases, the account holding institutions describe the fee on the customer's the monthly statement in such a manner as to make it appear that the bank did not impose the charge.

Thus, for example, an account holder's statement from a grocery store might read on one line:

"Greenway Supermarket - Debit Purchase –\$54.13".

The entry on the next line might read:

"Greenway Supermarket - PIN Debit Transaction Fee –\$1.00".

Regardless of what the account holding institution may have intended, their customers clearly interpret these statements to indicate that Greenway Supermarket charged them an additional \$1.00 for the transaction. We know this because our customers come into our stores, statements in hand, and demand that we "refund" the dollar "we (allegedly) have charged them for entering their PINs."

Retailers have also told us, that once they overcome their customers' initial disbelief and explain the true source of the charge, the customers' anger is immediately directed at their banks. But this job should not be retailers' responsibility. If the account holding institutions fee disclosures were accurately and adequately made, it would not be.

Solutions

The obscured debit fees discussed above fall into two broad categories: those which the retailer may be cognizant of and thus potentially within the retailer's power to disclose; and those that are uniquely within the knowledge of the account holding institution. In an efficient marketplace, all of these fees should be more clearly revealed through truly clear and conspicuous disclosures. Disclosure helps consumers make better informed choices. Whether that choice is to patronize a particular retailer using a particular payment type; or not to do business with a financial institution that imposes unacceptable fees, the consumer needs information to help make that decision. Although it is unlikely that we will ever obtain perfect disclosure of all information, the current system can be much improved.

As to the first type, retailers are aware of the interchange fees financial institutions require merchants hide in the cost of goods. These should be revealed. By continuing to allow financial institutions to discourage merchants from incenting the use of on-line debit systems by surcharging off-line debit at point of sale, consumers are incented to use a form of payment that drives up the cost of goods for all consumers.

Currently, retailers are forced to offer goods and services at a "blended" price. They are forced to guess what percentage of consumers are going to use expensive off-line debit cards whose hidden fees must be factored in to the prices charged to all customers.

A far better solution would be to allow retailers the option to freely set a price independent of the payment type and ask consumers to choose between a discount for an efficient payment product or a surcharge for an inefficient one. Some retailers may continue to offer a blended price for all of their merchandise. Others may reduce the price of goods and let consumers decide whether they wished to pay a one or two percent surcharge for the non-purchase card related benefits.

There is no question that the current system skews rational economic decision-making. It also penalizes those customers who cannot qualify for off-line debit cards. Poorer customers, who tend to rely more heavily on cash for their shopping, pay far more than they should when confronted with a blended rate. They are paying for the hidden costs of off-line debit cards that are often unavailable to them. If merchants were able to incentivize customers to use on-line debit, customers who do not qualify for off-line would no longer subsidize their wealthier neighbors.

As to the second category of fees, those within the unique knowledge of the financial institution – such as the PIN debit transaction fees – the Board needs to require that the account holding institutions more accurately and

adequately disclose those fees at a point in time they would best be understood by the consumer.

A bank that surcharges PIN-debit transactions at the point of sale should be required to fully disclose the fee it will charge and the name of the bank that will receive the fee. Moreover, banks that charge should also disclose that they are already receiving a fee via interchange, and bear all costs of these disclosures including the costs of any compatible hardware and software that merchants need to install. Consumers at the point of sale, where they interact not only with the merchant but also other consumers, should know that some banks charge high fees for PIN debit transactions while other banks do not charge consumers. Annual and periodic statement disclosures are insufficient. They get buried among a host of other disclosures and they are rarely clear. For example, they may say x number of free transfers, then a certain charge unless you have a balance of more than another amount. Only a concrete disclosure at the point of sale will make it clear and allow consumers to effectively comparison shop among banks and encourage efficiency in the marketplace.

We appreciate the Board's consideration of our comments.